

I. RATIONALE OF BANK EXAMINATIONS

What are the purposes of bank examinations? Although many answers to this question could be given, several fundamental reasons can be identified. The first relates to the maintenance of public confidence in the integrity of the banking system and in individual banks. Such confidence is clearly essential because the system's customers serve as the source of funding, without which banks would be unable to meet their most fundamental objective of providing financial services. The existence of unhealthy or deteriorating conditions, which may threaten this integrity, should be disclosed through the examiner's evaluation of the bank's capital adequacy, asset quality, management, liquidity position, and earnings capacity. Second, the periodic on-premise examination provides the best means of determining the bank's adherence to laws and regulations. Compliance with statutory and regulatory requirements has traditionally been given high priority by bank supervisors, and this posture has frequently been reaffirmed by Congress. A third response to the question concerns the role examinations play in protecting the financial integrity of the deposit insurance fund. That is, the examination process can help prevent problem situations from remaining uncorrected and deteriorating to the point where costly financial assistance by the FDIC, or even a payoff of depositors, becomes unavoidable. Finally, the examination supplies the supervisor with an understanding of the nature, relative seriousness and ultimate cause of a bank's problems, and thus provides a factual foundation to soundly base corrective measures, recommendations and instructions. The examination thus plays a very key role in the supervisory process itself.

II. THE UNIFORM FINANCIAL INSTITUTIONS RATING SYSTEM

Introduction

Upon the recommendation of the Federal Financial Institutions Examination Council, the Corporation's Board of Directors adopted a policy statement on November 26, 1979 entitled "Uniform Financial Institutions Rating System" (UFIRS). This statement was similarly adopted by the National Credit Union Administration, Federal

Home Loan Bank Board, Board of Governors of the Federal Reserve System and Office of the Comptroller of Currency. The rating system reflects in a comprehensive and uniform fashion an institution's financial condition, compliance with laws and regulations and overall operating soundness. Its primary purpose is to help identify those institutions whose weaknesses in the three aforementioned areas require special supervisory attention and/or warrant a higher than normal degree of supervisory concern. The effective surveillance and supervision of such banks has been and continues to be the first priority of the FDIC.

In accordance with the UFIRS, each bank is assigned a uniform composite rating based on an evaluation of pertinent financial and operational standards, criteria and principles. This overall rating is expressed through use of a numerical scale of "1" through "5" in ascending order of supervisory concern; "1" indicates the highest rating and least degree of concern, while "5" is the lowest rating and therefore the highest degree of supervisory concern.

To aid in implementing the uniform rating system, the Corporation utilizes a similar scale of one to five to assess the five key performance dimensions upon which the composite rating is principally based. These performance dimensions are commonly identified by the acronym "CAMEL": Capital adequacy, Asset quality, Management, Earnings and Liquidity. The balance of this section is devoted to a discussion of the guidelines and standards to be applied when assigning performance ratings and the composite rating.

Performance Evaluation

A description on the graduations utilized in conjunction with the performance ratings is as follows:

Rating "1" - Indicates strong performance, significantly higher than average.

Rating "2" - Reflects satisfactory performance, performance which is average or above; this includes performance that adequately provides for the safe and sound operation of the bank.

Rating "3" - Represents performance that is flawed to some degree and as such is considered

fair. It is neither satisfactory nor unsatisfactory but is characterized by performance that is of below-average quality.

Rating "4" - Refers to marginal performance, significantly below average. If left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.

Rating "5" - Considered unsatisfactory; performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, threatens the viability of the institution.

The above ratings are to be utilized to measure the five crucial performance dimensions commented on below.

Capital Adequacy - Rated in relation to the volume of risk assets; the volume of marginal and inferior quality assets; bank growth experience, plans and prospects; and the strength of management. Consideration should also be given to a bank's capital ratios relative to its peer group, its earnings retention and its access to capital markets or other appropriate sources of financial assistance. The Corporation's policy statement and regulation on capital adequacy must also be taken into account. Refer to the Capital Sections for detailed information.

Asset Quality - Rated in relation to the level, distribution and severity of classified assets; the level and distribution of nonaccrual and reduced rate assets; the adequacy of the allowance for loan and lease losses (ALLL); and management's demonstrated ability to administer and collect problem credits. Adequate allowances and a proven capacity to police and collect problem loans clearly mitigate to some degree the weaknesses inherent in a given level of classified assets. Asset quality evaluation should also take into consideration any undue degree of concentration of credits or investments, the nature and volume of special mention classifications, and the adequacy of lending policies and credit administration procedures. Refer to the Assets Sections for detailed information.

Management - Must be evaluated against virtually all factors considered necessary to operate the

bank within accepted banking practices and in a safe and sound manner. Thus, management is rated in relation to technical competence; leadership and administrative ability; compliance with banking regulation and statutes; ability to plan and respond to changing circumstances; adequacy of and compliance with internal policies; and depth and succession. The assessment of management also takes into account the quality of internal controls, operating procedures and all lending, investment and operating policies; and the involvement of the directors and shareholders. Refer to the Management Sections for detailed information.

Earnings - Rated with respect to the ability to cover losses and provide for adequate capital; earnings trends; peer group comparisons; the quality and composition of net income; and the degree of reliance on interest-sensitive funds. Consideration should also be given to the interrelationships between the dividend payout ratio, the rate of growth of retained earnings and the adequacy of bank capital. The adequacy of provisions to the ALLL, and the extent to which extraordinary items, securities transactions and tax effects contribute to net income, should also be assessed. Refer to the Earnings Sections for detailed information.

Liquidity - Rated in relation to the volatility of deposits; the frequency and level of borrowings; technical competence relative to structure of liabilities; availability of assets readily convertible into cash; and access to money markets or other ready sources of funds. The bank's liquidity position should be appraised over a period of time as well as on a particular date. The overall effectiveness of asset-liability management strategies should be considered, as well as the adequacy of and compliance with established liquidity policies. The nature, volume and anticipated usage of credit commitments are also factors to be weighed. Refer to the Liquidity Sections for detailed information.

Composite Ratings

Assessment of the CAMEL performance dimensions and their interrelationships represents the essential foundation upon which the composite rating is

based. Although the rankings of the individual CAMEL components should normally bear a fairly close relationship to the composite rating assigned, the latter is not to be derived merely by computing an arithmetic average of the former. Such a simplistic, mechanical approach may not necessarily reflect the extent of supervisory oversight of the institution that the circumstances demand. For example, it is quite conceivable for a bank to be operating with acceptable management, earnings and liquidity and yet have an excessive volume of adversely classified assets. A remedial program to address these asset weaknesses, as might be incorporated into an informal administrative action (discussed in the Memorandums of Understanding Section), could be an effective supervisory response. Consequently, a composite rating of "3" might be appropriate for such a bank, notwithstanding the fact that higher numerical assessments were assigned to a majority of the other CAMEL elements. Examiners or reviewers are not precluded from considering factors other than the CAMEL components themselves if, in their judgment, these other factors are deemed relevant to an accurate assessment of the overall condition and soundness of a particular bank. The important point to reiterate is that the principal purpose of the UFIRS is to identify, via the composite rating, those institutions which merit special supervisory attention and/or warrant a higher than normal degree of supervisory concern.

Composite ratings are defined and distinguished as follows:

Composite "1" - Institutions in this group are basically sound in every respect; any adverse findings or comments are of a minor nature and can be handled in a routine manner. Such institutions are resistant to external economic and financial disturbances and more capable of withstanding the vagaries of business conditions than institutions with lower ratings. As a result, such institutions give no cause for supervisory concern.

Composite "2" - Institutions in this group are fundamentally sound, but may reflect modest weaknesses correctable in the normal course of business. The nature and severity of deficiencies, however, are not considered material and, therefore, such institutions are stable and able to

withstand business fluctuations quite well. While areas of weakness could develop into conditions of greater concern, the supervisory response is limited to the extent that minor adjustments are resolved in the normal course and operations continue satisfactory.

Composite "3" - Institutions in this category exhibit financial, operational or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to financial condition, such institutions may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Institutions which are in significant non-compliance with laws and regulations may also be accorded this rating. Generally, these institutions give cause for supervisory concern and require more than normal

supervision to address deficiencies. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.

Composite "4" - Institutions in this group have an immoderate volume of serious financial weaknesses or a combination of other conditions that are unsatisfactory. Major and serious problems or unsafe and unsound conditions may exist which are not being satisfactorily addressed or resolved. Unless effective action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability, constitute a threat to the interests of depositors and/or pose a potential for disbursement of funds by the insuring agency. A higher potential for failure is present but is not yet imminent or pronounced. Institutions in this category require close supervisory attention and financial surveillance and a definitive plan for corrective action.

Composite "5" - This category is reserved for institutions with an extremely high immediate or near term probability of failure. The volume and severity of weaknesses or unsafe and unsound conditions are so critical as to require urgent aid from stockholders or other public or private sources of financial assistance. In the absence of urgent and decisive corrective measures, these situations will likely result in failure and involve the disbursement of insurance funds to insured depositors, or some form of emergency assistance, merger or acquisition.

It is the Corporation's view that disclosure of the composite rating to bank management is appropriate. Therefore, the examiner must begin the Examination Conclusions and Comments Schedule with the composite rating assigned. To enable the institution's directorate to better understand and appreciate the significance of this rating, the definitions of all composite ratings are printed on the back of the front cover of the examination report. It is important to note that only the composite rating and not the individual CAMEL performance rankings is to be indicated. Moreover, the examiner is not to disclose the rating to bank management at the time of the examination, since the Regional Office must concur with the rating and may, in some instances, wish to change it before the examination report is sent to the bank. The rating continues to be subject to the confidentiality restrictions imposed by Part 309 of the FDIC Rules and Regulations.

III. EXAMINATION PRIORITIES AND FREQUENCY CRITERIA

The Division's first priority is the effective surveillance and supervision of those banks requiring special supervisory attention. Identification of those banks is best accomplished by the examination process. Thus, annual full-scope examinations are required for all depository institutions. This interval may be extended to 18 months for small institutions if all of the following conditions apply:

1. The institution has total assets of less than \$100 million;
2. The institution is well capitalized as defined in Section 38 of the FDI Act, Prompt Corrective Action;
3. The institution was found to be well managed and accorded a composite rating of 1 at its most recent examination; and
4. No person acquired control of the institution during the 12-month period in which a full-scope examination would be required without this extension.

Extended Intervals

In addition, examinations may be conducted in

alternate 12 (or 18) month periods if the FDIC determines that an examination by the appropriate state supervisory authority in the interim period is acceptable. However, such alternate examinations should be accepted only for the following institutions: composite 1-rated institutions; composite 2-rated institutions; and composite 3-rated institutions if the composite rating is confirmed by the CAEL off-site monitoring system and no adverse trends are noted from other available information. The length of time between examinations of the state supervisory agency and the FDIC should not exceed 12 (or 18) months.

Other Situations

In addition to the preceding instructions, examinations should be performed in the following situations:

Newly chartered and insured institutions: A limited scope examination should be conducted within the first six months of operation, and a full scope examination should be conducted within the first twelve months of operation. Subsequent to the first examination and through the third year of operation, at least one examination should be performed each year. Extended examination intervals for small institutions should not be applied in the first three years of operation. Subsequent to the initial limited scope and full scope examinations, examinations may be alternated with the state supervisory authority if circumstances permit.

Institutions converting to insured nonmember status, including national, state member, thrift, and industrial bank conversions: For national and state member banks converting to insured nonmember status, a full scope examination should be conducted within twelve months of the last examination prior to conversion or the FDIC entrance examination. In rare instances, limited scope examinations may be conducted within three months of conversion, especially in banks that have not had an FDIC entrance examination.

Institutions which have had a change of ownership control: If the Regional Director's knowledge of the new ownership reflects a satisfactory financial and management performance record, standard examination intervals should apply. If new ownership is

unknown, a limited scope examination should be conducted within the first six months of the change of ownership control, and a full scope examination should be conducted within twelve months after the change. Thereafter, the standard examination intervals apply, and examinations may be alternated with the state supervisory authority if circumstances permit.

Insured institutions that have received FDIC assistance or been involved in purchase and assumption or deposit transfer transactions: Acquiring institutions with total assets in excess of ten times the deposits acquired, which are rated composite 2 or better, and which have an acceptable CAELDIFF score are exempt from the following requirements. Aside from the initial visitation, the requirements outlined in this paragraph are part of the ongoing supervisory process. If the institution is a state nonmember bank, a limited scope examination should be conducted within 30 days of the date of the transaction to determine how funds from the FDIC are being used and whether the bank is in accordance with the assistance agreement, if there is one. A second limited scope examination should be conducted within six months of the transaction. A full scope examination should be conducted within twelve months of the transaction. Thereafter, the standard examination frequency schedule applies. For national and State members, a cooperative program should be established with the other Federal supervisory agencies to ensure that all institutions receiving FDIC funds are properly monitored. The primary Federal supervisor has responsibility for the oversight of the institution and should be requested to keep the FDIC Regional Director informed of important developments. Individual larger transactions possess unique attributes requiring different scope and frequencies of examinations; consequently, the Regional Director will provide specific instructions in each case.

Coordination with State Authorities

Every effort should be made to coordinate examination and visitation schedules of all FDIC supervised institutions with State authorities to take advantage of State authority resources and to minimize duplication of effort and burden on the institutions.

Coordination with Other Federal Agencies of Bank

Holding Company Inspections and Subsidiary Institution Examinations

Federal bank regulatory agencies have agreed to conduct coordinated bank holding company inspections and lead bank examinations for: (a) any bank holding company with consolidated assets in excess of \$10 billion; (b) any bank holding company or its subsidiary lead bank rated composite 4 or 5 under the bank holding company rating system or the uniform rating system for banks; and (c) any bank holding company or its subsidiary lead bank rated composite 3 whose financial condition appears to have worsened significantly since the last inspection or examination. In multibank holding companies without a designated lead bank, the largest bank in total assets generally should be considered the lead bank. However, when other banks in a holding company are similar in size or larger than the designated lead bank, the condition and general performance trends of those banks together with the lead bank should be an important factor in establishing examination priorities. Whenever possible, examinations and inspections are also to be coordinated for all other bank holding companies. Bank examinations for subsidiary banks within a multibank holding company should be coordinated with the parent inspection to the extent practicable and where resources will permit.

Supervision of Interstate Banking Organizations and Chain Banks

A coordinated supervisory strategy for interstate banking organizations (both intra- or interregional) should be developed. The supervisory strategy developed should combine traditional supervision of individual units with an appropriate top-down approach to assess risk and monitor and coordinate supervisory actions. For these organizations, the Regional Director has discretion to omit, delay or modify existing examination frequency policy if: (1) the financial condition of the holding company and lead bank is considered satisfactory; (2) the condition of the subsidiary units is believed to be satisfactory; (3) control over all insured banks in the organization is effectively centralized; and (4) management is favorably regarded.

It is the policy of the Division to monitor and supervise banks that are part of a chain banking

organization in a manner that fully considers the financial impact of the consolidated chain on the individual institutions within that chain. A record system for chain banking organizations and for developing an overall supervisory strategy for those organizations is maintained. The most complete examination performed by the OCC and Federal Reserve should be retained.

Examination Intervals - Specialty Examinations

Specialty examinations generally should be conducted concurrently with safety and soundness examinations except when the size or arrangement of the department makes it impractical or inefficient to do so.

Only the Trust and Data Processing areas are eligible for extra extended examination intervals based on State examinations. The criteria for extending examination intervals in these areas are explained in the appropriate subsection below. Other areas must conform to the standard examination intervals listed below.

	Maximum Interval (months)
Specialty Composite 1	24
Specialty Composite 2	24
Specialty Composite 3	24
Specialty Composite 4	12
Specialty Composite 5	12

Bank Secrecy Act ("BSA") Compliance Examination. The FDIC is required by statute to review compliance with the Treasury Departments currency reporting regulations (31 CFR 103) and FDIC Section 326.8 at each examination of the bank. Accordingly, concurrent BSA reviews should be conducted with each safety and soundness or compliance examination (but not more than once per annum). Where a compliance examination is conducted concurrently with the safety and soundness examination, BSA reviews should be included in the compliance report. A separate BSA review should be prepared when no compliance examination is conducted with the safety and soundness examination. When the safety and soundness examination period has been extended, a BSA review should be done with any interim compliance examination.

Data Processing Facilities. Examinations of data processing facilities operated by an FDIC supervised institution or its subsidiary generally

should be conducted concurrently with safety and soundness examinations, in accordance with prescribed intervals. In those cases where the size or arrangement of the data facility makes this inefficient or impracticable, separate examinations may be conducted. Regional Directors have discretion to extend examination intervals for 1-, 2- and 3-rated data processing facilities up to 48 months if there has been an interim State examination that meets FDIC needs since the last FDIC examination. There should be no more than 24 months between the State examination and an FDIC examination for 1-, 2- and 3-rated data facilities. Additional examinations are encouraged when considered necessary by the Regional Director.

Independent data processing facilities are subject to the same examination frequency policy as financial institutions. Regional Directors should coordinate with other responsible Federal agencies for joint or rotated examinations of data facilities operated independently or by a holding company, or its affiliate, which service both FDIC supervised institutions and other institutions. FDIC participation is encouraged for examinations of national and State member institution data processing facilities, or their affiliated organizations, which provide services for FDIC supervised institutions.

Government Securities Dealer and Broker Activity. The Department of Treasury has not issued regulations requiring specific examination frequencies for examinations of Government securities brokers and dealers. Nevertheless, for efficiency, when a bank is both a municipal securities dealer and a Government securities dealer or broker, the examinations of both departments should be conducted concurrently in accordance with prescribed intervals for specialty examinations. A bank which is a Government securities broker or dealer, but not a municipal securities dealer, also should be examined in accordance with prescribed intervals. These examinations generally should be performed concurrently with other types of examinations but may be conducted independently as appropriate. Additional examinations are encouraged when deemed necessary by the Regional Director.

Municipal Securities Dealer Activity. The Municipal Securities Rulemaking Board Rule G-16 requires that an examination of the municipal securities dealer activities of institutions which

are registered with the SEC as municipal securities dealers is to be conducted at least once every 24 months. These examinations generally should be performed concurrently with other types of examinations but may be conducted independently as appropriate. Additional up examinations are encouraged when deemed necessary by the Regional Director.

Transfer Agent. Examinations generally should be conducted concurrently with safety and soundness examinations or with independent trust examinations, as appropriate, in accordance with prescribed intervals. If an institution is subject to the transfer agent registration requirements of Part 341 and also has a trust department, the transfer agent function should be examined at all trust department examinations. If the institution does not have a trust department but is subject to Part 341, the transfer agent examination should be performed with the safety and soundness examination. Additional examinations are encouraged when deemed necessary by the Regional Director.

Trust. Examinations generally should be conducted concurrently with safety and soundness examinations in accordance with prescribed intervals. Separate examinations of larger departments may be conducted when deemed necessary by the Regional Director. Regional Directors have discretion to extend examination intervals for 1-, 2- and 3-rated trust departments up to 48 months if there has been a State examination that meets FDIC needs since the last FDIC examination. There should be no more than 24 months between the State examination and an FDIC examination for 1-, 2- and 3-rated trust departments.

Insured Branches of Foreign Banks. The same priorities and frequency of examinations including instructions regarding other situations which are applicable to domestic FDIC supervised institutions are applicable to insured branches of foreign banks.

It can be readily seen from the above that decisions concerning examination priorities and frequencies, as well as the supervisory steps taken subsequent to the examination, are significantly influenced by the composite rating. Its importance should therefore be self-evident.

IV. SCHEDULING GUIDELINES

Periodic on-site examinations are critical to the supervisory process and are an integral part of the examination program. Diversified risks in the industry and the volatile performance and financial condition of individual institutions necessitate emphasis on more frequent and less structured supervision. Investigations, phone calls, limited scope examinations, correspondence and other forms of customized contact should be made as necessary. The purpose is to identify and obtain corrections in an institution's policies and procedures before serious financial problems develop.

Preexamination activities should include efforts to determine the activities engaged in and the condition of nonbank subsidiaries. If not determinable in advance, this should be conducted early in the examination in order to assess the necessity of and depth of examination of subsidiaries.

The success of this effort depends largely on the effectiveness of assignment scheduling and preordination. Examiner resources should be allocated and directed based on the best information available as to potential problems without over emphasizing the mere passage of time.

Anticipatory Supervision - To effectively prevent serious problems in an institution, the conditions and circumstances that may lead to problems must be identified and corrected early. Corrective action should be taken immediately upon identifying excessive risk taking that could lead to serious difficulties. History has clearly taught that when corrective action is not taken until conditions have deteriorated, it is often too late to avoid failure. Moral suasion and informal agreements are normally sufficient where the unacceptable risk-taking is identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant.

A prospective supervisory approach, entailing criticism of policies and practices before the unsafe and unsound condition actually develops calls for serious thought and studied reaction by examiners. Critical comments must be well supported and based on logic, prudent banking

standards, and the potential for harm. In questionable circumstances where formal action is a possibility, examiners should consult with the Regional Office while the examination is in progress regarding the material needed to support a potential action.

Scheduling Process - A goal of examinations of 1 and 2-rated institutions is to correct weaknesses before they cause serious difficulties and become a financial risk to the FDIC. Therefore, it is far more important to examine, or otherwise supervise, a bank if there is some reason to suspect a problem than if the bank merely has not been examined in a specified period of time.

Moreover, a formal examination may not be the most efficient use of resources in investigating the risk potential a bank may present. The objective is to assess the problem and, if necessary, devise a solution in the quickest, most efficient manner possible. Frequently, a telephone call or brief on-site visit may suffice. Sometimes such preliminary efforts will indicate that a full scope examination is appropriate.

In order for all available information to be considered, it is critical that the Field Office Supervisor and other appropriate personnel be aware of and have access to the scheduling process. Regional Directors should insure that copies of relevant correspondence any other information are made available. Procedures should insure that information that may impact a scheduling decision is documented and made available to the involved personnel. Individuals doing scheduling must review and consider this information.

Because of the variety of sources and forms of relevant information available, it is not possible to design a uniform system of information gathering and reporting. However, the list below includes some information that may come to the FDIC's attention and have an influence in prioritizing assignments. Some of these items, such as involvement in FDIC assistance transactions, have supervisory schedules specified in our policy. Others are merely information that, in and of themselves, may or may not raise a concern depending on what else is known about the bank. However, these or similar items may give a signal that requires further follow-up. Such clues should not be ignored. The list, while not all inclusive, indicate is the need for supervision to be

anticipatory and provides a reminder of some of the common sources of information that may warrant consideration when scheduling.

Information to Consider in Scheduling Examinations

Effective bank supervision entails the constant assimilation of information from numerous sources, both within and outside the FDIC. The appropriate response, if any, depends on the circumstances, supervisory action already underway, what is known about the institution and what can be learned from follow-up procedures. In some instances, the information serves as a "red flag," leading to an immediate examination. In less severe situations, the information is retained and factored into the process of scheduling future examinations. It is possible that a given piece of information can be derived from more than one source. Thus, some of the items listed below are included under more than one source.

Offsite Analysis and Monitoring

- CAEL Monitoring System
- Comprehensive Analytical Reports/Financial Interim Reports
- Growth Monitoring System
- UBPR Analysis
- Other:
 - Loss for the year or an interim period.
 - Rapid growth in assets or deposits.
 - Significant change in asset composition.
 - Significant change in liability composition.
 - Use of brokered funds.
 - Excessive dividends relative to earnings.
 - Excessive bond trading.
 - Other ratios or numbers that are unusual or have changed dramatically.

Applications, Notices or Other Bank Provided Data

- Change of control
- Merger
- Acquisition or establishment of a new subsidiary
- Acquiring party in a FDIC arranged transaction
- Change in external auditor
- Exercise of a new power or a new profit center

- Newly insured institution
- Affiliation with a 3-, 4- or 5- rated institution or holding company
- Cancellation of blanket bond insurance
- Large defalcation
- Review of CPA audit reports
- Large paydown or payoff of previously classified loans

Known Characteristics

- Excessive salaries
- Failure to pay competitive salaries
- Compensation linked to future performance such as income, loan volume or deposit growth
- Infighting involving senior bank officers and/or directors
- Significant litigation against the institution or in-siders
- Operating at the margin of Laws and regulations
- Management believed to be less than trustworthy
- Self-serving management
- Dominating management
- Inexperienced management
- Substantial outside business interests of a key officer
- Conducting business with questionable firms such as certain bond dealers

Examinations of Other Banks

- Hiring of a dismissed, unethical or marginal officer
- Refinancing poor quality loans
- Improper handling of correspondent bank accounts
- Advertising above market interest rates
- Undercutting on price and credit quality to increase market share of loans
- Large blocks of stock in the institution pledged as collateral
- Increased or unusual loan participations among affiliated or closely held institutions
- Banker with past due loans at another institution

Other Bank Regulators

- Improper handling of correspondent bank accounts
- Increased or unusual loan participations among affiliated or closely held institutions

- Large blocks of stock pledged as collateral
- Affiliation with a 3-, 4- or 5-rated institution or holding company
- Large defalcation
- Banker with past due loans at another institution
- Hiring of a dismissed, unethical or marginal officer
- Loans classified at other institutions

Media

- New chief executive officer or chief lending officer
- Adverse publicity
- Loss for the year or an interim period
- Adverse economic event in the community
- Natural disaster such as a flood, fire or earthquake
- Large defalcation
- Large financial commitment as sponsor or lead bank in a major project or development
- Banker death or disappearance
- Announcement of major new activity or department

Rumors/Observations/Other

- Change in external auditor
- High or sudden employee turnover
- Significant litigation against the institution or insiders
- Unusual activity in stock of the institution (price movement up or down or heavy trading volume)
- Institution advertising above market rates
- Significant change in the composition of assets or liabilities
- Questionable loans being booked
- Institution dealing with borrowers of questionable character
- Confidential or anonymous tips

V. GUIDELINES FOR RELYING ON STATE EXAMINATIONS

Section 349 of the Riegle Community Development and Regulatory Improvement Act of 1994, requires the FFIEC to issue guidelines establishing standards for the purpose of determining the acceptability of State reports of examination under section 10(d)(3) of the Federal Deposit Insurance Act. Under section 10(d)(3), a Federal banking agency may conduct an

annual, on-site examination of an insured depository institution in alternate 12-month periods (except those insured institutions with total assets of less than \$250 million for which an 18-month examination cycle is permitted) if the agency determines that a State examination of that institution conducted during the intervening period is adequate. The standards issued by the FFIEC are to be used at the discretion of the appropriate Federal banking agency.

The supervisory divisions of the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision (Federal banking agencies) responsible for the examination of state-chartered, insured depository institutions, and the branches and agencies of foreign banks that have been chartered by the States have a long history of coordinating with the State banking departments in fulfilling a mutual goal of promoting a safe and sound banking system. It is recognized that this close cooperation between the Federal and State regulators promotes efficiency in the examination process, reduces the regulatory burden on state-chartered, insured depository institutions, and improves the supervisory process.

The Federal and State banking agencies have worked together, to varying degrees, in the following areas:

- Conducting alternate, joint and concurrent safety and soundness examinations of insured depository institutions and of the branches and agencies of foreign banks that have been chartered by the States.
- Processing safety and soundness examination reports and applications on a timely basis.
- Using common examination report and application forms.
- Developing and issuing informal (e.g., board resolutions, memoranda of understanding or other similar agreements) and formal enforcement actions.
- Exchanging supervisory information.
- Offering Federal agency training programs to State Examiners.
- Providing access to the Federal agency data bases.

The FDIC intends to continue these cooperative

efforts to the maximum extent possible. It is recognized, however, that the adequacy of State budgeting, examiner staffing, and training are important factors to enhancing Federal and State coordination. The FDIC has entered into formal or informal arrangements or working agreements with most State banking departments. These working agreements or informal arrangements generally address the following areas:

- The number of state-chartered, insured institutions to be examined on an alternating basis by the State banking department and by the FDIC.
- The frequency of safety and soundness examinations.
- The type of examinations to be conducted (independent, joint, or concurrent) by each agency.
- The pre-examination procedures to be performed.
- The responsibilities of each agency for processing reports of examination.
- The responsibilities of each agency for conducting specialty examinations (compliance, information systems, trust, etc.).
- The procedures for coordinating informal and formal enforcement actions.
- The procedures for processing joint applications.
- The procedures for sharing supervisory information.

These working agreements or informal arrangements are structured to permit both Federal and State agencies the flexibility to conduct an independent examination subject only to notification to the other party. Generally, only institutions rated "1" or "2" are examined on an alternating basis allowing for a reasonable interval between examinations. The FDIC and the State banking department periodically meet and coordinate examination schedules.

A hallmark of a successful program has been the flexibility to tailor cooperation to the particulars of each State and to the specifics of individual banks within a State, plus the reality of changing circumstances at both the Federal and the State levels. The FFIEC

guidelines strive to maintain that flexibility.

Guidelines for Relying on State Examinations

The FDIC will accept and rely on State reports of examination in all cases in which it is determined that State examinations enable the FDIC to effectively carry out its supervisory responsibilities. The following criteria may be considered, in whole or in part, when determining the acceptability of a State report of examination under section 10(d) of the Federal Deposit Insurance Act:

- *The completeness of the State examination report. The State report of examination of a state-chartered, insured depository institution or a state-chartered branch or agency of a foreign bank should contain sufficient information to permit a reviewer to make an independent determination on the overall condition of the institution as well as each component factor and composite rating assigned under the "Uniform Financial Institutions Rating System" used for insured depository institutions and commonly referred to as the "CAMEL" rating system or the ROCA rating system used for branches and agencies of foreign banks.*
- *The adequacy of documentation maintained routinely by State examiners to support observations made in examination reports.*
- *The ability over time of a State banking department to achieve examination objectives. At a minimum, the FDIC will consider the adequacy of State budgeting, examiner staffing and training, and the overall review and follow-up examination process of a State banking department. Accreditation of a State banking department by the Conference of State Bank Supervisors is among the factors that also will be considered.*
- *The adequacy of any formal or informal arrangement or working agreement between a State banking department and the FDIC.*

The FDIC, as part of its routine review of State examination reports, will assess the quality and scope of the reports to determine whether they continue to meet the above general criteria. The FDIC retains the option in cases in which a State examination report appears insufficient or the condition of an insured institution, as indicated in the examination report or

other sources, appears to be seriously deteriorating, to conduct a follow-up examination.

The FDIC and State banking department will share, discuss and work to resolve any problems or concerns regarding the acceptability of each other's work or the operation of these guidelines and the alternating examination program, as well as other issues of mutual interest.

VI. PRE-EXAMINATION ACTIVITIES

Several benefits are associated with proper planning for an examination. First, it can help make examination scope decisions in terms of work to be performed and areas to receive special attention. Secondly, proper staffing for the examination, in terms of number of personnel and expertise needed, is more likely to be accomplished. Third, it can enhance the orderliness and efficiency of the examination generally. Therefore, minimum preexamination activities that should be performed pursuant to each safety and soundness examination include review of: the previous examination report; correspondence file; pending applications, if any; reports pertaining to trust, EDP, and compliance matters to determine if major problems are evident in those areas; and data from the Extended Monitoring System (EMS) and Uniform Bank Performance Report (UBPR). The last mentioned report may be used for either a summary or in-depth study of the bank on such factors as margin, capital formation rate, etc., and can therefore be of particular assistance in tracking the bank's financial performance since the previous examination. It should be noted that inasmuch as the UBPR is prepared from the data which banks provide in their Reports of Condition and Income, it is essential for examiners to review the accuracy of those Reports at each examination. Additional discussion on use of the UBPR is included in various sections of the Manual. The auditors reports, including management letters, should be reviewed by the examiner when planning the examination. If not available in advance, the reports should be obtained from the bank and reviewed early in the examination.

A final item that may be preliminarily determined as part of the planning process concerns the need for or extent of branch examinations. It is the

FDIC's basic practice to examine the various offices of a branch banking system on an as-needed basis only. Such decisions are within the province of the Regional Director or may be delegated by the Regional Director to the Field Office Supervisor or Examiner-in-Charge of a particular examination.

Generally, financial institutions should be notified in advance of an impending safety and soundness examination and be provided a "first-day" letter which details a list of documents needed to begin the examination. Management of the institution should receive this letter in a timely manner to allow completion of the request prior to the start of the examination. Use of such a letter improves the efficiency of the examination process and saves resources. Exceptions to this general policy may include problem institutions, situations where management and ownership of the institution are identical, or in situations where conditions are deteriorating rapidly.

VII. EXAMINATION PROGRAM

The program requires that a risk analysis be performed for all institutions prior to the start of the examination using all available information. The results of that analysis forms the basis for the scope of the examination and for allocating examination resources. By concentrating resources in areas with high risk potential and subsequently reducing resource allocations in other areas, substantial and effective time saving is realized.

The on-site examination program includes three tiers of examination procedures:

Tier I Examinations

Tier I examination procedures are used to ascertain the extent of problems in institutions that pose more than a normal risk to the deposit insurance funds. These procedures are used to examine 4- and 5-rated institutions and deteriorating 3-rated institutions. Additionally, these examination procedures are used in newly insured institutions during their first three years of operation and those institutions having a change of control involving unknown and/or unproven ownership or management. The procedures are also used in cases where deteriorating situations are discovered using Tier

II or Tier III procedures and the Examiner-in-Charge (EIC) decides to expand the examination to a Tier I level after conferring with the Field Office Supervisor (FOS).

Tier II Examinations

Tier II examination procedures are used to determine whether an institution poses more than a normal risk to the insurance funds. Examinations of all 1- and 2-rated institutions, with the rating confirmed by CAEL, should use these procedures. They also should be seriously considered for stable and improving 3-rated institutions. Institutions with component ratings below "2", with symptoms of high growth or asset restructuring, or institutions engaged in significant new activities or having just experienced a change of control (particularly involving management previously unknown to the Corporation) may require a somewhat more comprehensive review. However, such a review should not be expanded to the level of a Tier I examination unless sufficient deficiencies are identified and the EIC, with concurrence of the FOS, considers it appropriate to do so.

Tier III Examinations

Tier III examinations can be used for institutions in all rating bands to: (a) confirm existing UFIR and CAEL ratings; (b) determine if an institution's risk profile has changed and whether such changes pose an undue risk to the insurance funds; (c) determine progress in correcting previously noted deficiencies or monitor compliance with corrective programs and orders; and (d) evaluate other trends and situations. Tier III examinations are designed for flexibility; therefore, examination procedures will vary according to the size, type of activities conducted, and condition of the institution. The focus of a Tier III examination generally should be on areas exhibiting greater than normal risk and on areas of change within the institution. The standard examination report form should not be prepared, but a composite rating as well as component ratings should be assigned. If problems surface during the examination or the examiner concludes that a composite rating cannot be assigned without significantly expanding the scope of the examination, the scope should be expanded to a Tier I or Tier II level with the concurrence of the FOS. Alternatively, another examination can be scheduled at a later date using the more

comprehensive Tier I or Tier II procedures.

Standard Procedures for Tier I and Tier II Examinations Only

1. Examination Planning

Pre-examination planning is critical to the success of these procedures and is required for all examinations. Prior to each examination (or quarterly as part of an examination projection and scheduling process if considered more efficient), the FOS, or designee, shall review correspondence, CAEL, Growth Monitoring System, Comprehensive Analytical Reports, Financial Interim Reports, Uniform Bank Performance Reports other monitoring reports, prior reports of examination and other available information similar to the guide, lines listed in parts IV and V of this section of the Manual.

Based on that review, a concise written memorandum shall be prepared either to the FOS or from the FOS to the EIC outlining the proposed scope of each examination. The memorandum will include a brief comment on each CAMEL component and any significant deterioration in CAEL components or any CAEL component that is below a "3" for 1- and 2- rated institutions. Growth trends, management or ownership changes and prior examination criticisms should be addressed as necessary.

The FOS, or designee, shall prepare an examination resource budget based on the preliminary examination scope memorandum. This estimate should be discussed with and given to the EIC. Information from the FDIC data base necessary for the automated examination report should be downloaded to the regional or field office as necessary for EIC review prior to the start of the examination. In those situations where efficiency can be improved, the EIC or designee should conduct a preexamination visit to review information generated by the institution and to complete the preexamination planning.

2. Report Format

For Tier I and Tier II examinations, the Report of Examination should include the core section (pages 1 through 8), the confidential section (pages A through C), any necessary pages from the supplemental section, the Officer's

Questionnaire, and the signature of directors page.

Generally, the core financial pages of the examination report are prepared using the most recent quarter-end financial data available from the FDIC data base. Significant changes in the composition of the balance sheet between the examination as of date (financial date) and the asset review date should be reconciled (either by amendments to schedules within the report or within narrative comments of the report). There may be circumstances such as a major restructuring and/or significant errors which invalidate the use of quarter-end financial schedules. In such instances, the most recent month-end financial data may be presented.

3. Asset Review

Examiners are encouraged to streamline the loan review process to the extent practicable. Line-sheet documentation of nonproblem loans should be minimized. However, line sheets must contain sufficient supporting information to indicate why the line was passed or adversely classified.

4. General Procedures

- a. Maximum use of information available from the FDIC data base, either through the download process to the automated report of examination or by direct access to the mainframe computer, is strongly encouraged to enhance the examination process.
- b. Reports of Condition and Income should be checked simultaneously with examination report preparation. Only the most recent Report of Condition and the most recent year-end Report of Income are to be checked unless significant errors are found. When quarter-end institution financial statements are used in the examination report, no workpapers are needed to prepare the Statement of Financial Position or Earnings Schedule unless the number of errors and adjustments are significant and material. Any significant reporting errors should be noted in the examination report and the institution should be requested to file amended reports.
- c. Internal and external audit reports should be

reviewed to determine the scope of general ledger account reviews and internal routine and control deficiencies. Examiner resources should focus on the effectiveness of the institution's audit programs, the deficiencies reported in audit reports, and the corrective actions taken by the institution. Where audit and internal controls are inadequate, appropriate criticism should be noted in the report.

Examining personnel should not become involved in detailed "balancing" procedures. Examiner review should be limited to an evaluation of the institution's procedures with appropriate criticisms noted in the report. Balancing, verification of assets, and reconciliation of correspondent accounts should be performed only where deemed necessary because of inadequate controls.

- d. Special requests for management reports generally should be avoided. Instead, preexisting management reports should be used unless they are considered unreliable or unusable for examination purposes.

Specific Tier I Examination Procedures

Tier I examinations should follow the "Standard Procedures for Tier I and Tier II Examinations Only" outlined above and the specific Tier I procedures detailed below. Tier I examination procedures generally are the most comprehensive of the three tiers. For areas not covered by these procedures, examination instructions elsewhere in this manual should be followed.

1. Report Format

- a. Only those supplemental pages that are necessary to support criticisms or to communicate effectively the overall condition of the institution should be prepared and included in the report.
- b. "Institution-only" schedules should only be completed when such schedules are meaningful and necessary. Alternatives to "Institution-only" schedules may be substituted when appropriate.
- c. At subsequent examinations in which there is no new formal or informal administrative action contemplated, classified assets may be

listed by name and classified amount with the following exceptions:

- i) significant classifications contested by management,
- ii) criticized insider credits, and
- iii) special situations that require report presentation.

2. Policy

In situations where a formal or informal administrative action is contemplated or where the institution is a new or deteriorating 3-, 4-, or 5-rated situation, all criticized assets over the cutoff point and other significant assets of special interest should be accorded individual write-ups. Such write-ups should include only that information essential for an understanding of the specific problem. Excessive description of note terms, collateral, and credit history should be avoided; however, indications of lax and unsafe or unsound lending practices should be included in the individual write-ups. When write-ups are omitted, the examiner has the option of using a summary statement which explains the characteristics of groups of assets that were classified but not written up.

Specific Tier II Examination Procedures

Tier II examinations should follow the "Standard Procedures for Tier I and Tier II Examinations Only" as outlined above and the specific Tier II procedures detailed below.

1. Pre-notification

Institution management generally should be notified of an impending examination and be presented with a "first day letter" and an Officer's Questionnaire. The notification period should be sufficient to allow the institution time to prepare material required for the examination. Exceptions to this general policy may be warranted.

2. Report Format

- a. Supplemental pages that are not essential to support Page 1 criticisms are not to be included in the examination report or prepared for the workpapers.

- b. No "Institution Only" schedules are to be completed.
- c. Each CAMEL component must be evaluated. Comments should be brief on core pages. Significant criticisms should be presented on Page 1.
- d. The "B" Pages should be limited to listings of executive officers and directors with narrative comments included only when necessary. Review of the Board of Directors minutes and other minutes should be restricted to the lesser of the last examination (State or FDIC) or twelve months.
- e. Generally, classified assets should be listed by name and classified amount. The examiner has the option of using a summary statement to explain the characteristics of assets that are listed. Asset write-ups should be limited to:
 - i) significant classifications contested by management,
 - ii) criticized insider credits, and
 - iii) special situations that require report presentation.

3. Asset Review

- a. The volume of loans lined can be dramatically reduced from the Tier I level, and normally should not exceed twenty-five percent of the dollar volume of loans. If the EIC has confidence in the adequacy of the institution's internal loan review system and management, it is anticipated that the volume lined will be less than twenty-five percent.
- b. Generally, loans to be reviewed should include larger insider related credits, large loans, loans which are part of a group representing a concentration of credit, potentially high risk loans, known problem loans, and a sampling of new loans, high growth loan categories, and loans that have been modified or extended. Potential high risk loans include, but are not limited to, real estate construction and development, concentrations, highly leveraged transactions, and joint ventures. Coverage

for the loan review should be based on loan mix and growth, levels of risk diversification, adequacy of the internal review process, past due trends, and findings of prior state and FDIC examination reports. Maximum use should be made of the institution's own internal watch lists or self-prepared lists of problem assets if the procedures for creating them are adequate.

- c. Examiners are encouraged to utilize "discuss only" techniques for small and medium size delinquent and nonaccrual loans; (i.e., no review of credit and collateral files and no preparation of linesheets). Small and medium Other Assets and Other Real Estate should be evaluated in the same manner as similar sized delinquent loans. Narrative comments regarding individual classified assets under this method are not necessary.
- d. With the exception of criticized loans, direct inspection of original notes and collateral documentation is not required if sufficient descriptive information is otherwise available and the examiner has sufficient confidence in the institution's internal systems.
- e. Comprehensive listings of technical exceptions should not be prepared. Problems in the documentation area should be addressed with a general comment.

Examination Procedures for Tier III Examinations

1. General Guidelines

Tier III examinations should provide an overall assessment of an institution's condition and keep the Division of Supervision fully informed of changes or trends that may have a significant impact on the risk to the insurance funds. Such examinations should be performed with a small number of examiners over a short period of time (generally three to four days depending on size and complexity of the institution). Examiners are not expected to reach firm conclusions relative to specific operating areas or make explicit recommendations for corrective actions. Rather than assessing risk by using comprehensive testing and verification procedures, operating policies and procedures should be reviewed for adequacy and limited test checks performed to ensure overall compliance. The objective is for examiners to reach a level of comfort sufficient to

assess the overall condition of the institution and assign a composite rating.

Because of the CAEL offsite monitoring system CAMEL component ratings are to be included in Tier III examinations of commercial banks even if the components are merely brought forward from the previous examination. Components that are not based on the current Tier III examination should be identified in the report and in the "Comments" section of the examination system. (Component ratings for FDIC Tier III examination of OTS supervised thrifts are not required, however, to the extent they can be determined from the on-site examination and from other available) information, they should be included and entered into the examination database.)

2. Pre-examination Planning

Because of time and resource constraints, all available means should be used to improve efficiency and streamline the examination process. Providing an institution with advance notice of an impending examination and requesting that certain information be available upon arrival will help this process. Preexamination planning is another way of achieving better results. While the preplanning process for Tier III examinations generally will not be as comprehensive as that envisioned under Tier I or Tier II procedures, it nevertheless should be sufficient to enable the examiner to know where to direct the focus of the examination prior to starting the examination.

3. Report Format

For Tier III examinations, the standard form should not be prepared, however, the examiner can utilize appropriate schedules in preparing a memorandum which discusses the examiner's findings. Upon completion of the examination, the examiner is to prepare a memorandum to the Regional Director that a) defines the examination scope; b) discusses the general findings and overall condition of the institution focusing on those areas of concern that pose the most potential risk to the insurance fund; and c) assigns a composite and component ratings and discuss the base for the ratings.

Recommendations for corrections are not required, but recommendations for appropriate

follow-up action including additional examinations should be discussed as appropriate. In situations where a Tier III examination is used to evaluate a specific issue or trend is defined by the Regional Director, the matter should be addressed directly. No other report pages are necessary and given the time and resource constraints, none is expected.

With few exceptions, the results of Tier III examinations should be transmitted (in letter or other appropriate format) to the examined institutions. The exceptions generally should be limited to results of special purpose examinations defined by the Regional Director.

4. Examination Procedures

The procedures outlined below are provided only as a general guide for Tier III examinations and are not intended to be restrictive in nature. Normally the examination focus will be directed by results from the offsite monitoring systems and the analysis of other relevant information gathered prior to the start of the examination. Given the short time frame allowed, examiners have discretion to refocus their attention to other areas based on information provided during the examination and on their perception of the potential risk. Significant deviations that would expand the scope of the examination to another tier should be approved by the FOS.

- a. **Capital.** Calculate the institution's capital level taking into account estimated potential loss classifications determined in the asset quality evaluation. Assess the overall risk to the institution resulting from activities conducted in subsidiaries or affiliates of the institution or its holding company
- b. **Asset Review.** Evaluate the adequacy of written policies, procedures, and strategic plans governing such key areas as lending, investments and asset management. Determine from a small sample if these policies are applied in practice. Estimate potential classified assets based on information gathered from such internal records as problem loan lists, delinquency reports, nonaccrual reports, other real estate and similar management reports.
- c. **Management.** Review the minutes of the board of directors' meetings and evaluate key

management policies and reporting systems to determine whether the board and senior management exercise proper oversight authority and are informed adequately of operating results. Review major insider transactions and management benefit packages for evidence of abuse. Review recent external and internal audit reports to determine scope and general adequacy of internal controls. Significant changes which have occurred or are anticipated relative to personnel actions, future plans or new business activities should be discussed fully with management.

- d. **Earnings.** Using the institution's data, determine if the institution is operating profitably. Analyze the quality of those earnings and review for reasonableness the projected earnings for the next calendar year. Review rate sensitivity data to determine the effect of rate changes on those projected earnings.
- e. **Liquidity.** Review the institution's asset and liability management policies for adequacy, and determine, to the extent possible, if those policies are being followed in practice.

Region Discretion

Regional Directors have the authority to modify the scope, report format, and examination procedures described in this section as deemed necessary to take into account regional characteristics. Substantial deviations made on an individual institution basis only should be explained on Page A.

In determining which level of examination is appropriate, procedures are to be maintained to assure that an institution does not go an inordinate period of time receiving only a series of Tier III examinations and not a Tier I or Tier II examination.

Since the standards for a Tier II examination and especially a Tier III examination entail the exercise of a great amount of examiner discretion, it is expected that these examinations will be conducted by more seasoned examiners. This means an examiner who has conducted and is capable of conducting Tier I examinations on banks with comparable ratings. (For example, examiners should not be assigned to do a Tier II

examination of a 2-rated institution if they are not qualified to do a Tier I examination of the same institution if called upon.)

The procedures under this program may be expanded as necessary for purposes of training, after consultation between the FOS and regional office.

Policy for Examination Priorities and Frequency. It is recognized that full compliance with examination frequency guidelines set forth in this Manual may not always be attainable. To increase coverage of the FDIC examination program, one or a few persons may be sent to represent the FDIC at on-site state examinations of 1- and 2-rated institutions. This program may be particularly helpful in states where FDIC examination intervals are not normally extended based on state examination results. The FDIC examiner should remain at the institution long enough to determine that the scope of the state examination and the procedures used will result in findings that fairly represent the condition of the institution. In addition, the examiner may undertake such review and procedures as necessary to fill any gap. Upon completion of the review, the examiner should prepare a short memorandum to the Regional Director describing the scope of the review and recommending whether or not the examination can be used to extend FDIC examination intervals.

VIII. OTHER SOURCES OF EXAMINATION INFORMATION AND POLICY GUIDANCE

As stated earlier, the primary purpose of this manual is to provide policy guidance and direction to the field examiner which may then be applied in the safety and soundness examination process. Policy manuals or other instructional materials pertaining to other areas of examination interest, such as trust department operations, electronic data processing (EDP) activities, transfer agent and consumer compliance, have also been developed. Those areas were not included in this manual simply to enhance the organization of the material, keep the document reasonable in length, and thereby maximize its usefulness. However, exclusion of these topics in no way implies that these activities are not of interest to the safety and soundness examination. To the contrary, deficiencies in these other

aspects of a bank's operations can have a major impact on the institution's overall soundness. Therefore, it is critical for the examiner to be aware of the existence and significance of any deficiencies in these other areas. Separate examination reports or schedules have been designed to evaluate these functions, and it is the Corporation's policy that such examinations generally should be conducted concurrently with the safety and soundness review. Some exceptions to this concurrent examination preference are permitted and are detailed in the instructions pertaining to these specialty areas.

To emphasize and illustrate how weaknesses in these ancillary activities can adversely affect the bank whole, a brief overview of trust, EDP and compliance operations is provided.

Trust Department. A bank's trust department acts in a fiduciary capacity when the business it transacts, or the money or property it handles, is not its own or for its own benefit but belongs to and is for the benefit of others. This type of relationship clearly necessitates a great deal of confidence on the part of the bank's customers and demands a high degree of good faith and responsibility on the part of the bank. The primary objective of the trust department examination is to determine whether its operations or the administration of its accounts have given rise to possible or contingent liabilities, or direct liabilities (called estimated losses), which would reduce the bank's capital accounts. If the terms of trust instruments are violated, if relevant laws and regulations are not complied with, or if generally accepted fiduciary standards are not adhered to, the department, and hence the bank, may become liable and suffer losses. Obviously, if the magnitude of these losses is sufficient, the viability of the bank may be threatened. To aid the examiner in evaluating the trust department, an interagency rating system has been devised. Composite ratings of "1" (highest level of performance) through "5" (most critically deficient level of performance) may be assigned, based on analysis of six critical areas of the department's administration and operations.

Electronic Data Processing. Electronic data processing is now applied to numerous recordkeeping and operational areas in banks. These EDP services may be provided by the bank's own in-house computer system or the institution may arrange to have another financial

institution or independent data center perform these functions. As banks' reliance on the computer has increased, the potential consequences of receiving faulty data or suffering an interruption in EDP services have become much more serious. Thus, the need has arisen for comprehensive EDP examination policies and procedures. A primary objective of the EDP examination is to determine the validity and reliability of the records of the records produced by the automated system; therefore, the emphasis is on an evaluation of internal controls. Data processing operations are rated by the EDP examiner in accordance with a uniform interagency rating system based on an evaluation of four critical functions: audit; management; systems development and programming; and computer operations. The data center composite or summary rating is predicated upon the separate performance ratings assigned these four functions. A scale of "1" through "5" is used, wherein "1" indicates strong performance and "5" denotes hazardous performance.

Compliance. This term has become synonymous with those examinations that have as their principal objective the determination of a bank's adherence to various consumer protection and civil rights laws and regulations. These various statutes or regulations include, but are not limited to, Truth in Lending, Truth in Savings, the Community Reinvestment Act and Fair Housing. Noncompliance with these regulatory restrictions and standards may result in an injustice to the individual(s) affected and reflects adversely on the capabilities of the institution's management. Moreover, violations of the consumer laws can entail civil liability in many cases and criminal liability in some. If significant in amount, such losses could conceivably have an adverse financial impact on the bank. As is the case for EDP and trust operations, an interagency rating system for consumer compliance has been designed. It provides a general framework for evaluating the institution's present conformance with consumer protection and civil rights laws and regulations except for the Community Reinvestment Act and for assessing the adequacy of its operating systems to ensure continued compliance. A numbering scheme of "1" through "5" is used with "1" signifying the best performance and "5" the worst. A separate examination rating is assigned to each institution based on its performance in the area of community reinvestment. The four ratings are

outstanding, satisfactory, needs to improve, and substantial noncompliance.

In order to properly perform their duties, examiners must be knowledgeable of the principles, policies and practices contained in the aforementioned handbooks on EDP, compliance, trust and others. There are other reference sources also very relevant to the examination process and with which it is essential for the examiner to become familiar. These include the body of State laws and regulations which apply to the bank being examined; the rules, regulations, statements of policy and various banking-related statutes contained in the Prentice-Hall volumes; and the instructions for completion of the Consolidated Report of Condition and the Consolidated Report of Income. The last mentioned source is the principal reference for balance sheet and income statement presentation of various transactions and accounts in both the foregoing Reports and the Report of Examination.

IX. DISCLOSURE OF REPORTS OF EXAMINATION

The report of examination is highly confidential. Although a copy is provided to the bank, that copy remains the property of the FDIC. Without the FDIC's prior authorization, directors, officers, employees and agents of a bank are not permitted to disclose the contents of a report. Under specified circumstances, FDIC regulations permit disclosures by a bank to its parent holding company or majority shareholder.

FDIC regulations do not prohibit employees or agents of a bank from reviewing the report of examination if it is necessary for purposes of their employment. Accountants and attorneys acting in their capacities as bank "employees" or agents may review an examination report without prior FDIC approval, but only insofar as it relates to their scope of employment. The Division believes the definition of "agent" includes an accountant or accounting firm which performs an audit of the bank.

Reports of examination are routinely provided to the bank's chartering authority. Therefore, State bank examiners may review the bank's copy of an FDIC examination during a State examination.

X. EXAMINATION WORKPAPERS

Introduction

Workpapers should be a written trail of decisions and supporting logic that also indicate individual responsibility. They should provide written support for examination and verification procedures performed and the assertions of fact or opinion in the financial schedules and narrative comments in the report of examination.

Substance of Workpapers

All procedures performed during the examination should be sufficiently documented in the workpapers. All workpapers should be labeled with the institution's name and location, dated, and signed or initialed by the examiner or assistant examiner who prepared the document. Examiners should include in the workpapers a checklist of procedures performed at each examination.

Documentation should be prepared and retained in the workpapers for all job assignments regardless of whether the assignment involved an examination report page or a disclosed problem. The workpapers for each assignment should include a brief summary of the procedures performed and the basis for the conclusion reached.

Examiners should use FDIC standardized line sheets except in special situations where alternative forms, such as automated line sheets, provide a clear and substantial time savings and the same general loan information. Line sheets should contain sufficient supporting data to substantiate the pass or adverse classification of a line.

For selected areas of examination activity, workpaper forms have been created and are available as supplements to the respective pages in the automated report of examination. Additional guidance for their use is included in the Report of Examination Instructions. When examiner concerns warrant, any supplemental workpaper form may be included in the report of examination.

Filing of Workpapers

Workpapers relating to various major assignments (i.e. earnings, capital, balance sheet, etc.) should be segregated from other documents and placed in separate folders, envelopes, or binders. (If binders are used, workpapers for a number of major assignments can be incorporated into one binder if it is properly indexed with the required information.) Workpapers generated for the evaluation of internal routine and controls may be filed together under one major heading or separately under the major asset categories reviewed. Line sheets should be segregated from other workpapers, alphabetized, and securely banded.

Each folder, envelope, or binder should be appropriately labeled with the institution's name, location, and the date of examination and should contain a list of documents that have been prepared and retained for each category. At its discretion, each regional and/or field office may designate the major categories and supplemental lists for their respective office.

The workpaper folders, envelopes or binders should then be organized in a labeled expandable file or other appropriate centralized filing system. Examination workpapers should be promptly returned to the field office or other official storage place upon the conclusion of the examination. One of the detail supervisor's primary duties is to ensure that proper documents are retained in the workpapers, reviewed, checked for accuracy, and organized in a consistent manner. Notwithstanding, the examiner-in-charge is ultimately responsible for both the examination report and the supporting workpapers.

Retention of Workpapers

Line sheets should be retained for one examination beyond the examination at which the cards are purged from the active loan deck. Retention of workpapers beyond one examination should be confined to those banks with existing or pending administrative actions, or special documents relating to past insider abuse, documents which are the subject of previous criminal referrals, or other such sensitive documents. While the retention of workpapers beyond one examination is discouraged, field office supervisors have the discretion of retaining major schedules such as earnings, balance sheets, board minutes, and other pertinent workpapers for an additional examination.

XI. INTERNAL ROUTINE AND CONTROLS

The degree of examiner-performed audit procedures will, to a large degree, be dictated by the institution's practices. In those institutions which have a competent audit staff and adequate audit program, a review and evaluation of that department's audit coverage may suffice. Additionally, outside audits conducted since the last examination should be reviewed in detail, and management's actions to address weaknesses identified in the reports should be documented in examiner workpapers.

When an institution's internal controls are limited or determined to be inadequate, more in-depth auditing procedures should be conducted by examiners. These tasks include expanded account balancing, tracing or direct verification of bank assets, or other audit-related procedures deemed to be appropriate. Refer to the Internal Routine and Controls section for standard examination procedures useful in evaluating an institution's internal control environment.

An examiner's evaluation of the bank's internal routine and controls program must be documented in the workpapers. At a minimum, internal routine and controls workpapers should contain a summary assessment of the areas reviewed, including the procedures followed by examiners and the conclusions reached. The Internal Routine and Controls Workpaper schedule should be prepared and retained at every examination; any major deficiencies should be cited in the examination report. Additionally, documents which support any audit procedures conducted in other areas should likewise be retained.